DOW THEORY LETTERS INC.

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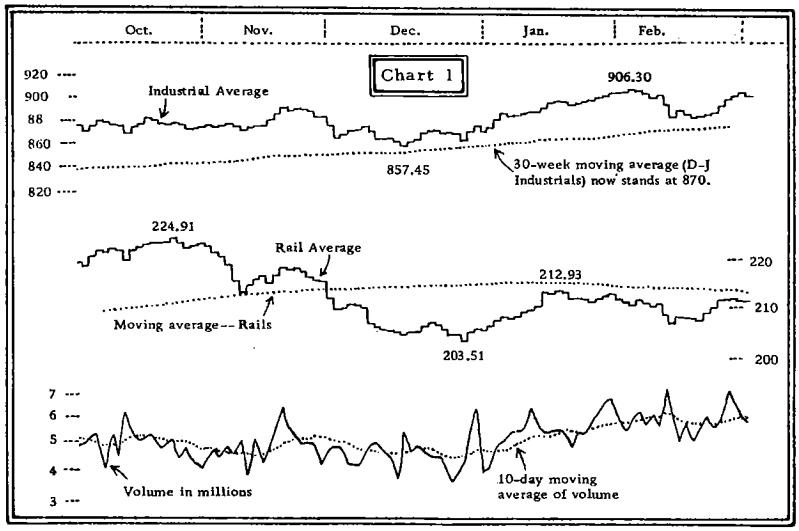
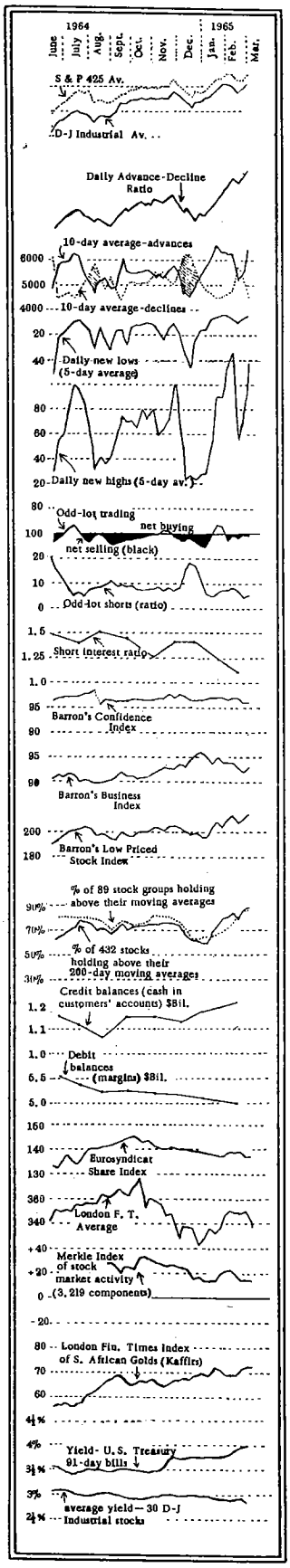
THE MARKET: The last confirmed highs of the bull market were recorded four months ago on October 20. Since then Industrials have pushed to new historic highs (see Chart 1) but the Rails have persistently refused to confirm. Are the Rails telling us that there is trouble on the horizon (or even that the bull market is over) or is this merely a pause for the Rails, a hesitation preparatory to a thrust first above the January high of 212.93 (see chart) and then above the October high of 224.91? From the technical or fundamental standpoint, this writer could make a good case for either the bull or the bear side. The divers currents in the market are seen from the striking position of the two Averages in relation to their own 30-week moving averages. Since November Industrials have held persistently above their own M.A. while Rails have remained stubbornly below their M.A. Sooner or later the two components must agree.

Conclusion: the primary trend was reconfirmed as bullish last October, and as far as Dow's Theory is concerned it should be taken to remain bullish until proved otherwise. The "otherwise" would be a high volume penetration of the December lows (857.45 and 203.51), but until (or unless) those critical points are broken, it would be well for market students to hold any skepticism in check.

The Composite Chart shows the two leading industrial averages within fractions of their 1965 highs. The A-D ratio is now at a new 1964-65 high, indicating that the mass of issues are obviously outperforming the high-grade Dow stocks. The 10-day averages of advances and declines have switched to the bull side, while the new highs have checked in bullishly (as have new lows). Odd-lotters remain on the selling side of the market, which must be considered a market plus. Barron's Confidence Index has dropped to 96.1, thus continuing a downtrend which has been in effect since last November, and this Index is saying that the Industrial Average has essentially seen its high for at least the next few months. The Low-Priced Stock Index is at a new high, reflecting heightened speculative sentiment. The percentage of stocks and groups holding above their moving averages is still highly bullish. Credit balances rose to a 1965 high last month, showing a build-up in customers' cash accounts, and this is normally bullish. However, the expert in these studies, Dr. Sloan Wilson, writes in a study which I received today: "A minor credit balance peak is forming . . . and the public has been selling securities. Historically the minor peak at this stage in the bull market has been reached either the same months as the DJIA (as in 1960) or one to two months later (1953, 1956, 1961). The present formation of the MCB is typical of the final stages of a bull market. It should be noted that the actual peak is a 'lagging indicator' of market activity." The debit balances dropped to a new low, showing (bearishly) that the speculator is still leaving this market. The London Market and the Eurosyndicat Index continue to bespeak of European deflation; they present distinctly bearish profiles.

The Kaffirs (gold) index may be used as a gauge of speculative sentiment for or against the pound and the dollar. A few months ago at the height of the gold "excitement" the price of gold was quoted in London at $35.19. " "Talk" from Washington and rescue operations in London knocked the gold price down to around $35.13. Last week (with almost complete silence on the

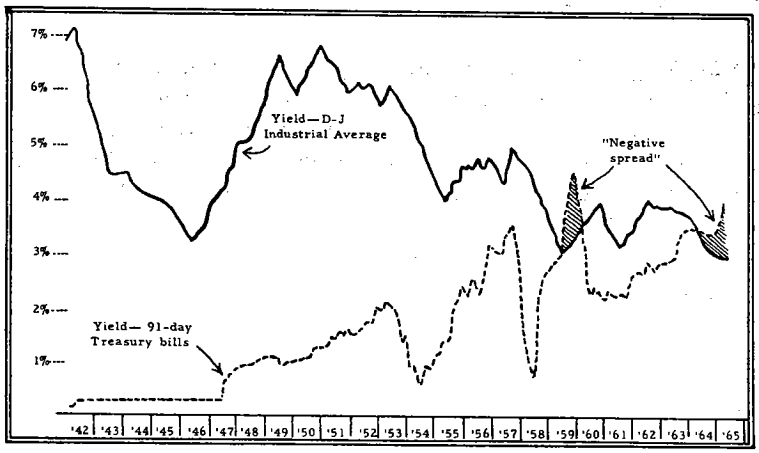



1964
1965
S & P 425 Av.
D-J Industrial Av.
Daily Advance-Decline Ratio
10-day average-advances
10-day average-declines
Daily new lows (5-day average)
Daily new highs (5-day av.)
Odd-lot trading
net buying
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low Priced Stock Index
% of 89 stock groups holding above their moving averages
% of 432 stocks holding above their 200-day moving averages
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Eurosyndicat Share Index
London F. T. Average
Merkle Index of stock market activity (3,219 components)
London Fin. Times Index of S. African Golds (Kaffirs)
Yield- U.S. Treasury 91-day bills
average yield—30 D-J Industrial stocks

gold picture) the price of gold rose steadily to $35.16 7/8, less than 2¢ from the crisis high! At the same time the Kaffirs index pushed to within a fraction of its 1964-65 high of 72.1. When a group acts superbly and nobody is noticing it, this writer is tempted to buy. Last week I added more Kaffirs to my holdings (specifically Western Deep Levels "A", which is to be the largest gold mining operation the world has ever seen).

Conclusion: the indicators still show strength in the U.S. market. However, there are enough indicators at variance with the bull picture to make this observer cautious — perhaps prematurely so.

INVESTMENT YIELDS: Sooner or later all investments must adjust to yield or the return on capital. This basic investment fact has been increasingly thrust in the background (and this is particularly true over the last five years) due to the extraordinary length of the bull market. "Growth" and "inflation" have been the two words which have done most to obscure the time-honored concept of yield. "And how about taxes," I am asked. "Hasn't the high cost of the capital gains tax also helped to downgrade the yield concept?" My answer is yes, but only on a temporary basis. For during a bear market, income is sure to decline and profits are certain to evaporate. At such times, investors' thoughts quickly return to the yield concept. The investor's goals during a bear market become a matter of safety, return on capital and lastly possible capital appreciation. For this reason the true investor (the man who automatically asks himself how much he can lose if things turn unexpectedly down) is always conscious of the inherent value of a safe and reasonable yield.



I have included a chart tracing the yields on two extremely important and fundamental investment media, the "blue-chip" stocks represented by the D-J Industrial Average and the safest of all short-term investments, the 91-day Treasury bills. The bills (as explained in Letter 279) are backed by the assets and taxing power of the U. S. Government; they are the shortest-term Treasury debt and are so safe that they are considered tantamount to cash.

This chart more than anything else represents a study in investor psychology. Note that in 1942 there was a positive spread of almost 7% in favor of bills. Good stocks were unwanted and yielded over 7% on average in 1942 while the safe Treasury bills yielded far less than 1%. During the 1949-53 period the positive yield spread ran as high as 5%. From 1956 onward the two lines closed rapidly. The first real upward push in bill yields occurred in 1957 as the Eisenhower administration invoked "tight money" in an effort to halt inflation. The faucet was quickly turned off in 1957 as the recession hit and bill yields were allowed to sink to below 1%. The second money crisis struck in late 1959 when the appearance of the famous " Magic Fives" (five year notes yielding 5%) upset the stock market and the money market. Authorities eased up on interest rates during the business recession and market decline of 1960.

Meanwhile, since 1958 the generally advancing stock market has forced stock yields into the 3% area — this at a time when bills were selling at historically high yields. Thus the period of late 1959 to early 1960 provided the first "negative yield spread" with bills actually yielding more than high-grade common stocks. This negative spread quickly disappeared during the market decline and money "ease-up" of 1960.

But from late 1964 to the present a new element has entered the picture. During this period Britain has staggered under her worst post-War monetary crisis, and she has been forced to raise her bank rate to 7%. Over the past year other nations all over Europe have been protecting themselves with periodic boosts in their respective bank rates. The U.S., hit by massive gold losses and buffeted by mounting distrust of the dollar, has been forced to defend itself by raising its own short-term interest rates. Thus, last week the yield on the 91-day Treasury bills climbed to 4.0%, and it is obvious (see chart) that the bills are now flirting with the all-time high of 4.6% touched in early 1960. Simultaneous with the new rise in bill yields, we have received "comforting" words from the Chairman of the Council of Economic Advisors (Mr. Ackley) to the effect that any efforts by the Fed to boost interest rates are not for domestic reasons but "for balance-of-payments reasons." Knowledgeable investors could not care less about the reasons for the rise in bill yields. But they are doubtlessly crossing their fingers as they watch the increasing negative spread between Treasury bill yields and the yield on the Dow.

This writer takes the increasing negative yield spread to be a definite danger signal. Consciously or unconsciously, large investment interests must ease up on their equity purchases in the face of this extraordinary spread. It becomes increasingly difficult to justify purchase of common stocks when the yields on bills is more than 1% above the yield on high-grade common stocks.

The rise in interest rates has other important implications. For instance, the interest cost on the national debt is now running over $10 billion annually (this figure can be appreciated when it is realized that the entire U.S. budget for 1929 was only $3.2 billion). Of the current $318 billion in U.S. Government debt, roughly $88 billion is now in short-term (under one-year) maturities. Therefore, a rise of 1% in bill rates will cost the U.S. an additional $800 million dollars in bills alone. Thus we can see that a rise in interest rates can constitute a "choking" expense for the U.S. Treasury (and for all individuals and companies who depend on borrowed money to do business).

Conclusion: The accompanying yield chart deals with two of the most fundamental relationships in the market. As a long-term consideration, this chart is saying to me: "Slow down. If you like a particular stock, take a chance, but hold large cash reserves and do not become overconfident." A proper investment ratio is now perhaps 15 to 25% in carefully selected common stocks, 10 to 15% in gold shares — preferably Kaffirs — and the rest in Treasury bills.

Because I consider the bill and Dow yields so important (and increasingly important during their current negative spread relationship) I am adding these two components to the Page 1 Composite Chart.

VERY PERSONAL OPINIONS: It is becoming increasingly clear (as this writer has pointed out on many occasions) that the U.S. and Britain are drifting like rudderless ships in the sway of a mighty tide. Britain, separated from bankruptcy only by the whim of her 11 creditor nations (headed by France), lowers her new import surcharge tax from 15 to 10% (under pressure from the 11), wistfully plays "the great nation" by announcing that she is exploring avenues of negotiation in Vietnam. Meanwhile, the British

Labor Party readies plans for stepped-up spending as part of its nebulous dream for the coming year. The dream is one in which Englishmen continue to spend and stay happy in the face of vanishing monetary reserves; the dream is one of a perpetual journey through never-never land while the rest of the world looks on and smiles.

On this side of the Atlantic it is becoming clear that President Johnson rules by consensus, moving in important areas (particularly international areas) only when he is pushed or forced to do so. The President presents the nation with a mixed bag of "tricks" to solve the balance-of-payments problems, a bag of tricks which the Wall Street Journal annihilates in its February 24 front page article. The President cajoles businessmen, he plays for time in Vietnam, he whips up 1937-style spending programs and 1965-style tax cuts.

Thus the stage is being set for high excitement during the remainder of the year. Just as the 1950's were in many ways stagnant and unexciting, I foresee the rest of the 1960's shaping up as years of change — perhaps shocking change. DeGaulle, noting the lack of leadership in Britain and the U.S., steps into the breech and by sheer brilliance and force of personality captures the imagination of Europe. He presents his plan for a new Europe, a Europe lead by France (as a nuclear power) and joined (yes, joined) by Russia (as the second European nuclear power). The U.S., instead of retrenching to gather its strength, continues to inflate. It thereby increasingly invites a major attack on the dollar. The U. S. News and World Report issue of March 1 contains an article which states that a secret meeting was held in Paris in late February, attended by top European and U. S. financial authorities. Verdict at the meeting: The Europeans will give the U. S. six months to show real progress in its balance-of-payments. After that, if there is no improvement — trouble. Title of the article: "Verdict in Europe; LBJ has 6 Months to Rescue the Dollar." This writer wonders what will happen if a few central bankers get nervous and decide to jump the gun.

SUDDEN DEVELOPMENT: As this is written the D-J tape states that the six Common Market nations have announced that they will shortly engage in joint sales of dollar holdings for gold. The Common Market, it goes on, built up $1. 5 billion in dollars during 1964 alone, and they now want to reduce dollar holdings. My opinion: This could be dynamite! Here is what it could mean: Rather than jump the gun individually, the Common Market six have agreed to take gold together in harmony. It means that DeGaulle is winning this fight and that West Germany and the other partners are unifying behind him to (1) stop the export of U. S. inflation via dollars, (2) load up on gold while it is still $35 per ounce, (3) prevent the U. S. from singling any one of the Common Market nations as the culprit who started the run. THE BIG QUESTION: will the U. S. fight the move with higher U. S. interest rates? Will we fight back in other ways? Or will we simply drift into a dollar collapse?

STOCKS: During the last three months this service has received its largest influx of new subscribers in over three years. Many of these recent arrivals have written to ask for more information about my methods of picking stocks. In the past I have written a good deal about stock selection, and such Letters as 248 devoted a whole section to a single criteria — in that instance relative strength. Letter 264 explained my "stock qualification guide", and it is worth examining that list again (this is actually my method of selecting stocks).

(1) Relative strength (R.S.) charts of all major stock groups (and over a thousand individual stocks) are kept at this office. But it is to the groups that I turn first. Particularly desirable is a group which has reversed to the upside following an extended (three to five year) decline in R. S. Such a group is liable to be "sold out" and in strong hands. Furthermore, a group which is turning up after perhaps a four year decline in market popularity or R. S. is very liable to be in line for a major advance. This type of thinking, for example, is what prompted me to pick McCrory at 12 in Letter 258. The Retail Variety Chain group was then turning up after a major decline in R. S. which had continued for almost three decades. The subsequent explosion in McCrory and W. T. Grant (the latter picked in Letter 259 at 32) was the result. Therefore, my initial attention goes to group R. S.

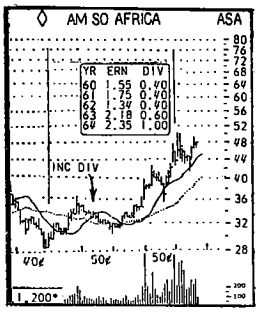
(2) The second effort (assuming I have found a favorable group) is obviously aimed at the individual stocks in the group. Here a number of criteria are used. It should be remembered that when a group turns up in R. S. , the reason is usually fundamental. It follows, therefore, that almost all the stocks in the group are going to be affected to some extent by whatever fortunate set of circumstances are aiding the group. When a whole group is reversing to the upside, some stocks will always be well on their way to higher levels while others in the group will be "basing" or just starting up. It is to the latter ("just starting up") that I am usually attracted.

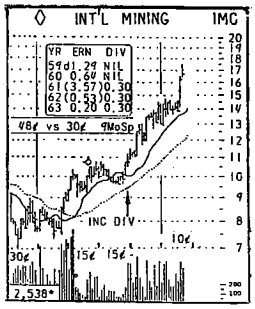
How do I go about picking the actual individual stocks? First I examine long-term charts (monthly charts covering at least five years) of all the stocks within the chosen group. I try to discover upside R.S. reversals in stocks which have not yet undergone important rises. In selecting issues, I am guided by the hope of picking stocks which are capable of a rise of 25% or more. To do this, the individual stock usually requires a substantial base. One of the best mechanisms for measuring the size of a base is the point & figure chart, and subscribers will note that almost all stocks selected in these Letters have accompanying P & F charts or at least comments regarding the size of the base in the given stock.

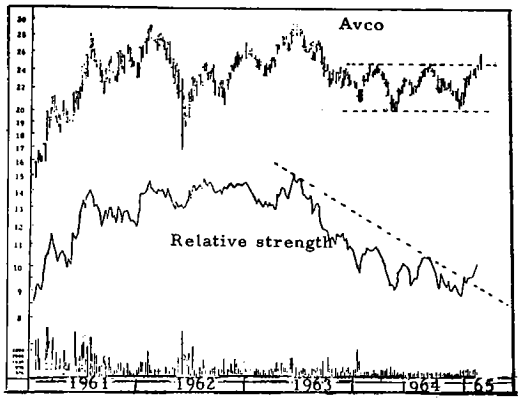
Moving averages are also of great use in gauging the position of an individual stock. From a timing standpoint, the most propitious moment to purchase a stock is when the price pushes above the 200-day moving average. If such timing corresponds to a P & F "breakout" the timing is doubly fortunate. Frequently, these two points come close together, and I then advise waiting until the rise betters the 200-day moving average and also satisfies the requirements for a "buy point" on a P & F chart. I never advise purchase of a stock which has pushed too far (say 20 to 30%) above its 200-day moving average; such purchases usually lead to

frustration and a probable correction in the given stock.

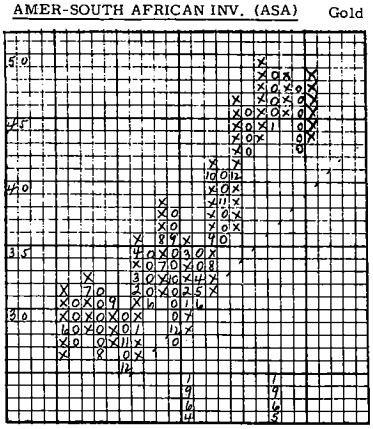
(3) Fundamentals can be difficult to assess, but they are helpful. All too often, however, I find that fundamentals are "dated," and that accumulation has taken place under cover of bad news in an industry or a stock (remember the horrendous news about the rail issues just before that move started!) I find that data regarding insider and fund buying can be helpful — often valuable. Thus the fact that insiders were buying heavily into Burroughs at 24-26 was an excellent hint that something was in the wind (see Letter 265 on BGH). Insider or fund buying is far from an infallible "tip" however, but it is a very definite plus to know that the insiders and funds are on your side.



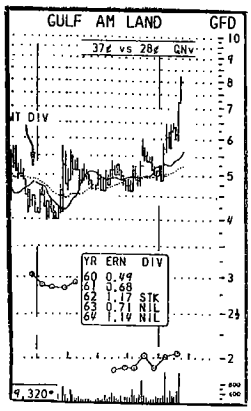




AMER-SOUTH AFRICAN INV. (ASA) Gold



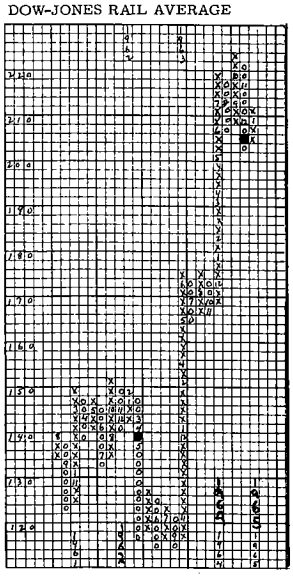
Gulf-American Land was recommended at 6 to 6¼ in Letter 277 and again in Letter 278. This issue then rocketed up to 8¼ and is now holding near the high. I am holding GFD as protection against the possibility of more speculative market sentiment. If it cannot stay above 6½, however, I'll sell it and "call it a day." Phillips-Van Heusen is up a few points from where I recommended it (23), and if the market holds up this one should continue to do well. Food Fair recommended in the last Letter if "it touched 26" did just that and the stock has now turned bullish with a fairly large base. International Mining has been recommended here since it was in the 12-13 area. Last week it did some acrobatics and climbed to 17½. This took it more than 30% above its moving 30-week moving average (see Chart) which now stands at 12¼. For this reason I played it safe and took half profits in IMF.



I include a point & figure chart of Amer-South African which turned bearish on P & F when the stock touched 44. ASA will turn bullish again if it can make it back to 50. I would prefer owning the actual Kaffirs to ASA, but for those who want the holding company I would say buy ASA on stop at 50. If you already own ASA, of course stay with it. Avco has broken out of a long rectangle and reversed a two-year downtrend in relative strength. Earnings for this one could be as high as $2.25 for the coming year. Over the past three months (courtesy TSR Reports, Palisades Pk., N.J.) insiders bought 13 thousand shares of AV, funds bought 31 thousand over same period. Given any strength in the market, AV should be a "buy" for a move to at least its old "double top" at around 30; can be bought now and sold if it breaks a sensitive trendline below 24.

TWO INTERESTING ITEMS: The P & F chart of the D-J Rail Average turned bearish (second black square) when that Average touched 208 last November. The last time the Rails turned bearish on a P & F basis was in April, 1962 (first black square). As stated before, the movement of the Rail Average tends to reflect professional opinion. The carrier Average would have to 226 to turn bullish on a P & F basis again.

DOW-JONES RAIL AVERAGE



The international chart shows ten leading foreign Averages. The Belgian, Canadian and Dutch Averages are near their recent highs while the S. African Industrial (not gold) Average appears as the strongest Industrial Average in the world. England, France, Germany, Italy and Japan are all in bear markets, while Australia is beginning to look very "toppy." The fact that averages of the two leading European powers, Germany and France, are bearish testifies to the fact that these two nations mean business when they say that they intend to stop inflation in its tracks.

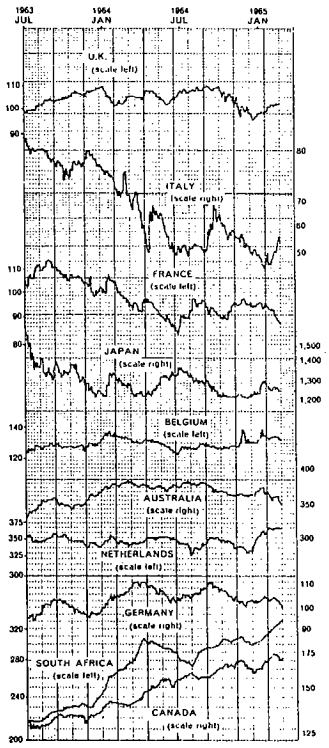


Chart of Avco courtesy of Traders Research, 1431 Pearl St., Alton, Illinois.
P & F charts courtesy of Chartcraft, Inc., Larchmont, New York.
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